THE FT'S YEAR IN FINANCE

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Lessons from history

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Contagion in an age of austerity

The year has been punctuated by the thud of falling dominoes, writes **Lionel Barber**, FT Editor

This was the year the sovereign debt crisis struck Europe. One by one, the dominoes fell: Greece, Ireland, Portugal, Spain and Italy. Bond yields soared, bank shares crashed, governments collapsed. At the time of writing, financial markets were focused on the risk of a second credit crunch.

The Financial Times has occupied a ringside seat since the global financial crisis erupted in the summer of 2007. Our commentators and reporters have tackled the crisis in all its dimensions: the sub-prime lending spree in the US, excess leverage of the investment banks, regulatory failures, global economic imbalances, the sovereign debt squeeze, and now the existential threat to Europe's single currency, the euro.

This report is intended to give a flavour of the FT's coverage of these momentous events. Naturally, there are gaps.

There is no space for our popular A-List commentators such as George Soros, Mohamed El-Erian of Pimco and Nouriel Roubini (though samples of their best writing can be found online at blogs.ft.com/the-a-list and www.ft.com/finance-2011). Other contributions that can be found online cover important topics such as the growth of the shadow banking sector in China, the increasing influence of sovereign wealth funds based in the Middle East and Asia, and the anti-capitalist Occupy movement that surfaced in big cities around the world.

The Occupy movement was inchoate, but it spoke to a widespread disillusion with capitalism – specifically financial capitalism. The public remains angry and frustrated at the cost of rescuing the banking system, a cost largely born by taxpayers rather than shareholders or bondholders. Bankers have done their cause scant good by continuing to award themselves generous remuneration packages (though in the end, of course, shareholders have the final say).

An egregious example of skewed incentives and compensation emerged with the collapse of MF Global, a trading house run by Jon Corzine, formerly co-head of Goldman Sachs, governor of New Jersey and US Senator representing the Garden State. Mr Corzine's dream was to turn MF Global into a rival of Goldman, and he made a big bet on a recovery in European bond markets. The bet was not only ill-timed, it was uncovered.

John Gapper's parable of Emperor Corzine's Goldman clothes subtly draws on Hans Christian Andersen's fairy tale to capture Mr Corzine's delusional position. But it also raises questions about the effectiveness of post-crisis regulatory scrutiny in the US.

This is a theme reprised by Megan Murphy and Haig Simonian in their account, available online, of a $2.3bn rogue trading scandal at UBS, the oft-troubled Swiss global investment bank.

The way Jamie Dimon, head of JPMorgan Chase, tells it, the banks are being forced to double-down on capital to achieve lower risk weights. Mr Dimon told Tom Braithwaite, our US banking editor, that the Basel III international reforms were "anti-American". But as our reporter explains: banks are deleveraging by cutting the size of their balance sheets, further reducing credit to a battered economy. Gillian Tett, US managing editor and a former Tokyo correspondent, spells out the comparisons with Japan's lost decade and therefore the policy dilemma for the US Federal Reserve.

'The condition is that you need to be infinitely rich before you start'

Credit rationing is already generating a slowdown in the east and raising the spectre of a 2012 recession in Europe. This is doubly alarming in the light of the eurozone's troubles. Martin Wolf has written many brilliant commentaries this year, particularly on the eurozone. His column on Germany's fateful policy choices is one of the most outstanding.

"We are witnessing," he writes, "a lethal interplay between fears of sovereign insolvency, emerging sovereign illiquidity and financial stress." For a different perspective, readers should turn to John Kay, our resident wit. He compares Europe's response to a martingale betting strategy: each time you lose, you increase your stake: to the point at which a win on the next game would recoup all your losses and leave you ahead. "Of course," John Kay writes, "the condition is that you need to be infinitely rich before you start."

In September, the FT published a series on the future of banking. Patrick Jenkins, banking editor, Brooke Masters, global regulation correspondent, and Tom Braithwaite wrote the opening article on how the big investment banks are adapting to the new age of austerity. Leverage will be lower – and so will returns. "Banks will go back to basics such as acquiring deposits, lending them on, cash management, trade finance and foreign exchange."

That would suit Martin Wolf, who was a member of the Independent Commission on Banking set up by the UK government to look at the causes of the crash, determine how to boost competition in the sector and make recommendations to strengthen safety in the system. The ICB's recommendations, chiefly to end the implicit cross-subsidy of risky investment banking via retail deposits, will be implemented by the government in 2012. Bob Diamond, chief executive of Barclays, countered in the inaugural Today Business Lecture that banks needed to become "better and more effective citizens". Martin Wolf takes him at his word.

And, finally, for a touch of light relief, there is Tim Harford's tongue-in-cheek account of the extraordinary growth of Ponzi schemes. As Charles Ponzi himself might have said: "Tings ain't wot they used to be."

Inside

The hunt for a common front

Analysis

Patrick Jenkins, Brooke Masters and **Tom Braithwaite** find little consensus on how to fix the bank system

Dorotea, a thirty-something one-woman ceramics entrepreneur based in the remote forests of Peru, knows all about the global financial crisis. She might not be familiar with the intricacies of Lehman Brothers' demise in 2008, nor with the succeeding slew of regulations intended to fix a broken banking system. But she knows she is lucky. If she were trying today to get the loan of 1,200 sol for a new kiln that she secured a few years ago, she would be disappointed.

Like virtually every bank worldwide, her micro-lender, Mibanco, has had to reduce the risks to which it is exposed, and is no longer granting credit to poverty-stricken businesspeople. "We're still lending," says her local manager. "But we're looking for lower risks – not so poor, not so micro."

Three years after the depths of the worst financial crash in eight decades, it is clearer than ever that the crisis many thought ended two years ago is dragging on – and in some ways, particularly in the US and across the eurozone, intensifying.

Businesses and politicians say credit is either unavailable or too expensive. Banks complain that profits are being squeezed so hard that investors are deserting them. Regulators are left wondering whether their natural crisis response – to draft tough new rules – is building a stronger system as intended or rather exacerbating the problems of a fragile global economy.

With hindsight, it is clear the structure of the sector in the years before 2007 was an accident waiting to happen. Institutions had grown distorted in the pursuit of bumper profits. They held little equity capital to protect themselves – and what they did have was in many cases amplified by as much as 50 times with debt instruments. Vast profits were made from borrowing cheaply, often short term, and assuming the risks inherent in products from domestic mortgages to complex derivatives were negligible.

Today, those building blocks of profitability – generating returns on equity of up to 25 or 30 per cent, five times the norm for many blue-chip industrial companies – are gone. Many banks now hold triple the equity they used to, and as much as six times the liquid funding. Typical leverage multiples are down to 20. Risks have been reassessed. And profits have slumped. On the banks' own preferred measure, ROE, which has historically flattered performance by relating returns only to those thin equity cushions, the best they can aspire to now is half the pre-crisis range.

Citigroup, a big US casualty, has shrunk its assets – loans, mortgages and other credit – dramatically. "The world has changed," says Alberto Verme, joint chief executive of its European operations. "Banks are going back to basics – getting deposits, lending them on and managing what are increasingly important requirements for customers – cash management, trade finance, foreign exchange."

Regulators in turn have pushed through a raft of rules on the amount of equity and liquidity institutions should hold.

Though most are part of the new standards from the Basel committee, the global regulator, to be phased in by 2019, analysts and investors have applied pressure for early compliance. Their maxim for the past couple of years has been simple: the higher the capital ratio – specifically equity as a proportion of risk-weighted assets – the better.

"It's quite clear that the banking system today is safer than it was a few years ago," says Bob Penn, partner at global law firm Allen & Overy. "Is it regulatory action or simply market response to a crisis?"

Either way, the crisis has found a second wind. The direct costs borne by governments three years ago of bailing out broken banks, combined with the indirect costs of the economic slowdown that accompanied the crash in the sector and long-term overborrowing coming home to roost, have shown up in unsustainable sovereign debt burdens from Europe to the US. That is feeding back into the still-fragile banking system, as parts of institutions' traditionally safe portfolios of government bond investments have slumped in value.

"In this balance-sheet restructuring process, the uncertainties right now are within housing and with governments," says Richard Brown, chief economist at the Federal Deposit Insurance Corporation, which guarantees US bank deposits and supervises the industry.

"The irony is that one of the balance sheets that is furthest along in being repaired is that of US financial institutions. That is one of the pluses on the ledger for the economy."

Some believe the root problem is that reforms have been insufficient. "The structural changes that have been introduced and planned will not make [the system] safe enough," says Professor Anat Admati of Stanford University.

By way of example, the latest targets of the markets' bearishness are French banks that, with the support of their national regulator, have resisted following the drive led by Switzerland, Sweden and the UK to boost capital levels to new heights. At the same time, BNP Paribas, Société Générale and Crédit Agricole all have outsized exposures to Greece.

Policymakers are struggling to fix the flawed fundamentals of eurozone economies without burning through banks' capital cushions. But in the meantime, the supply of short-term liquid funding to many institutions across the continent is drying up, in a re-enactment of the jitters that killed off the likes of Northern Rock in the UK and Lehman in the US in 2007-08.

> 'Liquidity for many banks is getting shorter term or is reliant on government measures'

"The fundamental problems in the euro area are only worsening over time," says Ulf Riese, finance director at Sweden's Handelsbanken, whose low-risk business model has made it a rare safe haven among European peers. "Liquidity for many banks is getting shorter term or is reliant on government measures."

The September 9 deadline for private-sector holders of Greek sovereign bonds to sign up to a voluntary deal to extend the term for up to 10 years could trigger another round of bearishness across the eurozone. Bankers predict participation will fall short of the 90 per cent target, which could endanger the next tranche of Greek bail-out money if politicians feel the burden is not being shared fairly. The fragility of the markets has prompted some normally hardline reformers apparently to question the wisdom of an unbending approach. Andrew Haldane, executive director for financial stability at the Bank of England, last month praised the handling of bank regulation in the 1930s by US President Franklin Roosevelt – specifically loosening rules during the Great Depression in a successful bid to boost lending.

Bankers, unsurprisingly, agree. They point out, for example, that lenders' traditional role of mediating between the capital markets and corporate borrowers may no longer be economically viable, now that so many have been downgraded by credit rating agencies. "Nowadays, a lot of banks have a higher cost of funding than corporates – that makes it very difficult to be a lender to corporates," says Mr Riese.

When it comes to blue-chip clients, with easy direct access to capital markets themselves, that may be a problem only for their banks. Loans have traditionally been a loss-leader product, giving the lender a relationship with a customer, and a basis on which to cross-sell more profitable business.

But for small and medium-sized enterprises, banks' shortage of funding poses a real problem, both politically and economically. SME lending, which attracts higher regulatory capital charges, is especially sensitive in Europe, where most employment is by smaller businesses.

Some reformers believe regulators must keep up the pressure – for instance, limiting banks' ability to pay dividends to shareholders until they have boosted capital levels further through retained profits.

"There will only be long-term prosperity if we underpin the health of our financial system," says Paul Tucker, deputy governor of the Bank of England. "Had the authorities not pressed the banking system to have more capital, we would probably be in a worse position now."

The Institute of International Finance, however, which represents the industry globally, estimated this week that complying with new rules will force financial groups to come up with $1,300bn in additional equity. They predict the cumulative effect could push up interest rates on loans by 3.6 percentage points over the next five years and cut global gross domestic product by 3.2 per cent by 2015.

Those who favour a more pragmatic approach to reform have a broader complaint, too – that the process risks creating a whole new set of distortions that could prove just as dangerous as those that preceded the 2008 crash.

Jan Hommen, chief executive of Dutch bank ING, says cracking down on banks will shift risk into "shadow" institutions, from hedge funds to industrial companies branching into lending. "I am nervous that the regulated financial markets – which are basically the oil that greases the economy – are being too tightly regulated," he says.

There are gripes, too, about the side-effects of multiple uncoordinated reforms. "If politicians and regulators are not capable of joining up their thinking, what hope do we have of a sensible outcome?" says Allen & Overy's Mr Penn.

Taxpayer anger about the 2008 rescues has also limited the options available for dealing with future crises. For example, the Fed cannot direct emergency lending to a single institution.

"I worry that the risk of runs is still very much there," says Phil Suttle, chief economist at the IIF, referring to the restrictions on the Fed. "If I'm an unsecured shorter-term depositor with the banking system that isn't clearly insured, I've probably got more rather than less worries at this point."

A still bigger concern is the distorting effect that the clampdown on western banks might have on the few remaining growth markets – most strikingly Asia.

"In very macro terms, China clearly has a long way to run in terms of growth. But that doesn't mean there won't be bumps along the way," says an Asia expert at one bank. The continent has steered clear of much of the west's regulatory reform, so US and European banks are diverting an artificially high volume of investment into the region – from lending to establishing new trading floors – helping to inflate existing bubbles.

But the biggest existential question remains the basic one of lending capacity. And only when the economy's weak demand for credit finally strengthens, testing the banks' capacity to lend with their new capital and liquidity constraints, will the world really know whether the future of banking stacks up.

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Houses not yet in order: the shortage of funding for banks is a real problem for small businesses

Asia's banks 'The fish always stinks from the head'

Liu Mingkang, China's chief banking regulator, has a folksy way of explaining his work: "The fish always stinks from the head," **writes Simon Rabinovitch**.

This belief that regulation must focus on banks' head offices can be seen in China's zeal to enforce the Basel III rules. The China Banking Regulatory Commission has been pushing ahead with a set of rules that is stricter than what has been agreed internationally.

Basel III's minimum tier one common equity requirement is 4.5 per cent; China has set its bar at 5 per cent. For the leverage ratio, a safety net if risk-weightings fail, Basel III requires at least 3 per cent of total assets; China has opted for 4 per cent.

Beijing has ordered its biggest banks to meet the capital requirements by 2013, whereas banks in developed markets have until 2015. Chinese bankers have been quick to fall in line. The difference with Europe and the US is easy to explain. Top bank executives are appointed by the Communist party and answer to the government.

China's banking sector had a capital ratio of 12.2 per cent at the end of June, well beyond Basel III standards. Banks around Asia are in a similar position.

Japan has stood out, however, as its regulators worked hard to protect banks from having to move too quickly to increase their capital stocks.

But the absence of complaints from Chinese bankers does not mean that the new regulations will be painless. Wu Xiaoling, a former central bank vice-governor, has been unusually candid, warning that banks deemed systemically important could face a large funding gap in the next five years. Concern that they will have to tap equity markets to meet capital rules is one reason for their lacklustre share performance in the past year.

The tough rules obscure the main risk for Chinese banks: too much government. With all major lenders owned by the state, their commercial decisions are heavily dictated by Beijing.

A case in point was their surge in lending in the global financial crisis, when the government used the banks to fund its stimulus spending. The damage in bad loans is just beginning to emerge and analysts say it will cast a shadow over the Chinese banking sector for years to come.

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Patenting the Ponzi: an extraordinary tale of growth

Undercover economist

Tim Harford takes us behind the scenes with a grand schemer

"Two world poker champions and other leaders of one of the largest internet card gaming sites turned the company into a massive Ponzi scheme, wrongly taking out more than $440m from player accounts, US officials alleged on Tuesday."

The Financial Times, September 21 2011.

Office of Charles Ponzi & Sons:

"Mr Ponzi, have you seen what the US Justice Department is saying about this poker website?"

(Sighs) "Don't tell me, Massimo: they say it's a Ponzi scheme?"

"You've got it in one, Mr Ponzi."

"This is outrageous! Call my lawyer! Who do these bastards think they are? I am Charles Ponzi! The Ponzi scheme is my creation!"

"I don't think Full Tilt Poker are planning to infringe on the trademark."

"I'm not worried about Full Tilt Poker. I'm upset about these sanctimonious asses who keep saying Ponzi, Ponzi, Ponzi and they know nothing!

"If a company goes bankrupt but the managers get paid, it's a Ponzi scheme. Internet bubble companies are a Ponzi scheme. If it's a government policy they don't like, it's a Ponzi scheme.

"Where does it stop? Some kid steals baseball cards from a candy store and it's a Ponzi scheme? They think I'm a shoplifter or something?"

"What do they say the poker website did anyway?"

"Well, the US Justice Department says that some of the company directors paid themselves handsomely while they were struggling to take in money from new players."

"Why were they struggling to take in money?"

"Because the US government was trying to make online poker and all related transactions illegal."

"Oh well. It doesn't matter to me if they did it or not. What these clowns at the US Justice Department are describing is not a proper Ponzi scheme at all.

"A proper, classic, elegant Ponzi scheme is an investment offer that pays investors high returns. You know this."

"I know this, Mr Ponzi."

"You know this. The high returns attract new investors – and often the old investors keep their money in too. As long as the money coming in from new investors is enough to cover the occasional investor who cashes out – and of course the dividends taken out by the scheme's creator – then all is well. It is a thing of beauty."

"It certainly is, Mr Ponzi."

"If these guys looted the cash register while their company was going bankrupt, that's not worthy of the great name of Ponzi. I'll sue the prosecutors for tarnishing my brand name."

"And Mr Perry."

"Who?"

"Governor Rick Perry. He's running for president."

"What about him?"

"He said that social security was a Ponzi scheme."

"He said what? Who the hell does he think he is?"

"I think he thinks he's the next president of the United States."

"Well screw him! I'm Charles Ponzi! Social security isn't a Ponzi scheme! It's just a welfare payment that's going to be more expensive because of demographic change."

"I understand, boss. But – well, isn't it a little bit of a Ponzi scheme? I mean, it depends on each generation being larger than the previous one."

"Crap! It does not depend on that at all. Sure, it's cheaper if there are lots of young people around. But social security is perfectly affordable with a bit more tax or a slightly lower payout. It's nothing like a Ponzi scheme. With some adaptations it could run forever. But a good, audacious Ponzi scheme can become unsustainable in months."

> 'It will become easier to operate a real Ponzi scheme. So everything is not so bad'

"Shall we sue Mr Madoff too, then, sir?"

"No, no. Bernie is fine, Bernie carried off a proper Ponzi scheme. He sure kept it going for a long time. I cannot complain. I wish we had trademarked the Ponzi name, but I cannot blame Bernie for that."

"That's very big of you, Mr Ponzi."

"I suppose I should not be too upset. The more people carelessly talk about Ponzi schemes, the more confused everybody becomes. It will become easier and easier to operate a real Ponzi scheme. So everything is not so bad."

"You look tired, sir. Let's get some pizza and relax."

"A good idea, Massimo! I have some vouchers from this internet thing, Groupon. It seems the local pizzeria is offering some great deals."

"Ah. Mr Ponzi?"

"Yes?"

"Have you heard what some people are saying about Groupon?"

"My lawyer, Massimo! My lawyer at once!"

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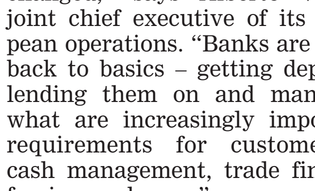
Japan's interest rate dilemma casts a shadow over the Fed



Gillian Tett

Slightly more than a decade ago, I spent many hours at the Bank of Japan talking with officials about the paradoxes of ultra low rates. At the time, BoJ officials faced intense pressure from politicians and markets to boost growth; so they were duly implementing quantitative easing or their zero interest rate policy (Zirp).

However, the more they experimented with Zirp, the more sceptical they seemed about whether it really worked. The essential problem, they moaned, was that Japan's financial system was so broken it had become bifurcated: some companies desperately needed cash, but could not borrow because the banks were too risk-averse to assume credit risk, with or without Zirp.

However, healthy companies that did not need loans were finding it laughably easy to raise money. The result was a classic liquidity trap. And, as such, it left men such as Masaru Hayami, then BoJ governor, privately joking he really ought to raise rates – not cut them – since that, at least, would make long-suffering savers happy.

These days, the shadow of Japan is hanging over America's Federal Reserve (and not just because when Ben Bernanke was an academic, he used to write extensively on Zirp, and question whether Hayami was trying hard enough). In September, the Fed announced a variant in its home-spun version of Zirp: the so-called "Twist" operation, a move that sees it purchasing long-term bonds and mortgage securities, in place of short-term debt and government bonds.

This aims to lower long-term borrowing costs, and thus supply more credit to the business sector and mortgage world.

However, the Fed's problem – like Japan a decade ago – is, as the International Monetary Fund puts it in its latest financial stability report, that the economy is "bifurcated". Many large American companies, particularly those with global operations, are highly profitable and liquid. Unsurprisingly, for them "bank lending conditions and capital market financing remain easy", the IMF notes.

But many small and medium-sized companies – or the entities that typically create jobs inside the US, not overseas – find it hard to raise funds. A survey conducted by the International Franchise Association in Washington, for example, notes that whereas in March half of its members expected credit conditions to improve soon, six months later less than a quarter expect any easing; even as Treasury yields fell.

There is bifurcation in the mortgage market too. In late September Freddie Mac announced that the average rate on a conventional fixed-rate 30-year mortgage had tumbled to an all-time low of 4.01 per cent (and in western US regions, just 3.95 per cent), following Operation Twist. Wall Street bankers are buzzing with tales of savvy financiers refinancing home loans at rock-bottom rates.

> The Fed's problem – like Japan a decade ago – is that the economy is 'bifurcated'

But, as a report from the Institute of International Finance says, "In order to take advantage of lower mortgage rates, borrowers have to refinance their mortgages, which can be difficult to impossible, if the value of home equity has been eroded." Twist, in other words, does nothing for households with negative equity (estimated to be about a quarter of the total); nor those in distress (another quarter.) Worse still, Fannie and Freddie are not allowed to refinance their loans. Little wonder mortgage approvals are falling fastest in communities with high levels of negative equity and repossessions – precisely the area that the Fed wants to help.

Is there any solution? At the IMF meetings in late September, proposals fell into three strands. Some voices, particularly in Europe, want regulators to "urge" the banks to lend, via targets or political pressure. Witness, for example, the calls made subsequently by the Financial Policy Committee in the UK (which also faces a bifurcation problem). However, bank lobbyists retort that a better solution would be to water down efforts to tighten capital standards; according to the IIF, what is hurting credit provision is excessive regulation and uncertainty.

Meanwhile, some economists are pressing the Fed and other central banks to get more directly involved in lending themselves. Alan Blinder, the former vice-chairman of the Fed, for example, likes the idea of the Fed purchasing more mortgage bonds, or even corporate loans; another proposal floating around is to securitise loans to small American businesses, which could then be purchased by the Fed, via another version of Twist.

Such ideas may help at the margins; purchasing securitised bundles of SME loans, for example, seems sensible. But none is a silver bullet, least of all when eurozone woes are making US banks even more risk-averse. If Hayami were still alive today, it would be interesting to know what advice he would give; and even more interesting to know how Bernanke might respond.

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FT Special Reports Research 2011

Dear FT Reader,

We hope you find the FT Special Reports a useful and stimulating read. The FT publishes approximately 200 Special Reports every year and to help us tailor our editorial as closely as possible to your interests and needs, we are conducting a survey to gauge your feelings about FT Special Reports. We would also like to ask you about your media habits and working life and would be grateful if you would help us by completing this questionnaire and returning it using the reply paid postage service.

Your reply will be treated in the strictest confidence – the results will only be used in statistical format and you will not be contacted by any other company. As a token of our appreciation, every reader who completes and returns a questionnaire by Friday 13th January 2012 may enter the free prize draw to win £200 (or local equivalent).

Thank you for your help.

Michael Skapinker
Editor, Special Reports and Supplements

GENERAL RESEARCH ACTIVITY

Before we ask about the FT Special Reports, we would first like to ask you about how you research information in general.

Q1 How often do you conduct research on a company, industry, subject area (e.g. sustainable business) or country for work purposes?

	Company	Industry	Subject Area	Country
4-5 times per week	❑	❑	❑	❑
2-3 times per week	❑	❑	❑	❑
Once a week	❑	❑	❑	❑
2-3 times per month	❑	❑	❑	❑
Once a month	❑	❑	❑	❑
Less often	❑	❑	❑	❑
Never (Go to Q4)	❑	❑	❑	❑

Q2 When conducting research for work purposes, which resources do you use? *Please tick all that apply*

- Internal company resources e.g. Library ❑
- Online search engines e.g. Google ❑
- Online research databases e.g. LexisNexis ❑
- News websites e.g. FT.com ❑
- News publications e.g. FT ❑
- Online discussion forums ❑
- Online blogs ❑
- Social media ❑
- External research company ❑
- Other (Please specify) ________ ❑
- None of the above ❑

Q3 When quoting a research source, which of the following are most important to you? *Please select up to three*

- Reputability of source ❑
- Trust in the source ❑
- Editorial independence ❑
- Source recognised by others ❑
- Up to date content ❑
- Integrity ❑
- Relevance of information ❑
- Other (Please specify) ________ ❑
- None of the above ❑

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Q4 How much of this FT Special Report did you read, or do you expect to have read by the time you have finished with it?

- All of it ❑
- Most of it ❑
- About half ❑
- About a quarter ❑
- Less than a quarter ❑
- Don't know ❑

Q5 Apart from yourself, how many other people will read your copy of this FT Special Report?

- None-Just myself ❑
- 1 ❑
- 2 ❑
- 3-4 ❑
- 5-9 ❑
- 10+ ❑

Q6 Overall, how would you rate this FT Special Report?

- Excellent ❑
- Very good ❑
- Fair ❑
- Poor ❑

Q6a How often do you read FT Special Reports in the Financial Times newspaper?

- Regularly (at least three our of four reports) ❑
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- Rarely ❑
- Never ❑

Q7 What will you do as a result of reading this FT Special Report (or may have done as a result of reading a previous Special Report)? *Please tick all that apply*

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Q8 Which, if any of the following FT Special Reports recently published by the FT did you read or look at? *Please tick all that apply*

	In Print	Online
Investing in Poland (2nd November 2011)	❑	❑
The Connected Business (9th November 2011)	❑	❑
The Business of Formula One (10th November 2011)	❑	❑
Watches & Jewellery (12th November 2011)	❑	❑
Aerospace (14th November 2011)	❑	❑
Brazilian Capital Markets (15th November 2011)	❑	❑
Business of Consulting (17th November 2011)	❑	❑
Private Banking (21st November 2011)	❑	❑
Nigeria (23rd November 2011)	❑	❑
Cop 17 Insight (25th November 2011)	❑	❑
Arts Collecting (26th November 2011)	❑	❑
Business Education: Innovative Law Schools (28th November 2011)	❑	❑
FT Health: Combating Aids (1st December 2011)	❑	❑

Q9 How do you generally find out about FT Special Reports? *Please tick all that apply*

- Look at Guide to the Week ❑
- See advance notices in the paper ❑
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Q10 Which subjects would you be interested in the FT covering (in future special reports)? *Please write in*

Q11 Which geographical regions would you be interested in the FT covering (in future special reports)? *Please write in*

Q12 Please indicate how strongly you agree or disagree with the following statements about FT Special Reports *(on a scale of 1 to 5 where 1 is Disagree Strongly and 5 is Agree Strongly).*

	Disagree Strongly	2	3	4	Agree Strongly
They are well written	❑	❑	❑	❑	❑
They are useful	❑	❑	❑	❑	❑
They provide information I cannot find elsewhere/would not otherwise see	❑	❑	❑	❑	❑
The writing is objective	❑	❑	❑	❑	❑
They help keep me informed about trends/development	❑	❑	❑	❑	❑
They are accurate and up to date	❑	❑	❑	❑	❑
They are authoritative and credible	❑	❑	❑	❑	❑

Q13 In your own words, can you tell us the value to you in reading FT Special Reports? *Please write in*

Q14 Aside from general reading, in which, if any, of the following ways do you use FT Special Reports? *Please tick all that apply*

- For a better understanding of countries/regions I do business with ❑
- To research new markets or countries ❑
- To understand emerging trends and developments ❑
- To find out about specific business sectors ❑
- To find out more about the industry I work in ❑
- To make better informed business decisions ❑
- To make my investment decisions ❑
- To find new business partners/to uncover new business opportunities ❑
- To prepare for a business trip ❑
- To prepare for meetings with clients or other contacts from the country or industry concerned ❑
- To incorporate into presentations, reports and other documents ❑
- To show to clients, suppliers or other contacts ❑
- In my role as a teacher/lecturer as teaching material ❑
- Other (Please specify) ________ ❑
- None of the above ❑

Q15 In which of the following ways have you accessed FT Special Reports in print? *Please tick all that apply*

- A copy of the FT purchased especially for a report ❑
- A copy of the FT purchased for general content (not specifically for a report) ❑
- Office/someone else's copy ❑
- Library/archive ❑
- Purchased/sourced back copy ❑
- Other (Please specify) ________ ❑
- None of these ❑

USE OF SPECIAL REPORTS ONLINE

Q16 Did you know that FT Special Reports are also available on FT.com?

- Yes ❑
- No (Go to Q20a) ❑

Q16a How often do you access the FT Special Reports on FT.com via browser on PC/laptop, FT.com via browser on tablet/mobile or FT app on tablet/mobile?

	FT.com via PC/laptop	FT.com via tablet/mobile	FT App on tablet/mobile
4-5 times a week	❑	❑	❑
2-3 times a week	❑	❑	❑
Once a week	❑	❑	❑
2-3 times a month	❑	❑	❑
Once a month	❑	❑	❑
Less often	❑	❑	❑
Never	❑	❑	❑

Q17 In which of the following ways have you accessed FT Reports online? *Please tick all that apply*

- Navigation bar on FT.com ❑
- Search function on FT.com ❑
- Search engine e.g. Google ❑
- Click through from a link in an FT email ❑
- Click through from a link on FT.com ❑
- Click through from an advertisement on FT.com promoting Special Reports ❑
- Bookmarked page as a favourite ❑
- Typed in the URL from a report read in print ❑
- Other (Please specify) ________ ❑
- None of the above ❑

Q18 For what reasons do you access the FT Special Reports section on FT.com? *Please tick all that apply*

- To find out about upcoming reports ❑
- For archiving/reference purposes ❑
- To search for reports on a particular country/industry/subject ❑
- In addition to a report read in print ❑
- Prefer to read a report online than in print ❑
- Don't have access to a print copy of Special Reports ❑
- To access additional content relating to a report e.g. video, interactive graphics ❑
- To download a PDF of a report ❑
- Other (Please specify) ________ ❑
- None of the above ❑
- Do not use FT.com to access FT Special Reports ❑

Q19 What would make you use the Special Reports section on FT.com more frequently? *Please tick all that apply*

- Improved search function ❑
- Reports being regularly updated with new content after being published ❑
- More interactive features ❑
- Better linking to further online content ❑
- An online community of other readers interested in the same subjects ❑
- Improved ability to share content with others ❑
- Other (Please specify) ________ ❑
- None of the above ❑

OTHER MEDIA CONSUMPTION

Q20a In which of these publications do you ever read or look at special supplements/reports? *Please tick all that apply*

	In Print	Online
Economist	❑	❑
Wall Street Journal	❑	❑
International Herald Tribune	❑	❑
Forbes	❑	❑
Fortune	❑	❑
Harvard Business Review	❑	❑
Bloomberg Business Week	❑	❑
The Times	❑	❑
The Telegraph	❑	❑
The Guardian	❑	❑
The Independent	❑	❑
Other Print (Please specify) ________		
Other Online (Please specify) ________		
None of the above	❑	❑

Q20b Which publication do you think runs the most informative special supplements/reports? *Please tick one*

	In Print	Online
Economist	❑	❑
Wall Street Journal	❑	❑
International Herald Tribune	❑	❑
Forbes	❑	❑
Fortune	❑	❑
Harvard Business Review	❑	❑
Bloomberg Business Week	❑	❑
The Times	❑	❑
The Telegraph	❑	❑
The Guardian	❑	❑
The Independent	❑	❑

Q21 Are you...?

- Working full-time ❑
- Working part-time (including semi-retired) ❑
- Looking for work ❑
- Retired ❑
- Homemaker ❑
- Studying ❑
- Other (Please specify) ________ ❑

Q22 Which of the following best describes your position/ job title?

- Owner/Partner ❑
- President/Chairman/CEO ❑
- Chief Operating Officer ❑
- Managing Director ❑
- Chief Financial Officer/Finance Director ❑
- Chief Information/Technology Officer ❑
- Other C-Suite title ❑
- Board Member ❑
- Departmental Director/Head of Department/Vice President ❑
- Other managerial level/executive ❑
- Technical Specialist ❑
- Consultant ❑
- Financial Professional (e.g. IFA, Broker, Trader, Investment/ Fund Manager, etc) ❑
- Professionally qualified (i.e. Doctor, Teacher, Engineer etc.) ❑
- Administration/Clerical ❑
- Elected representative ❑
- Other (Please specify) ________ ❑

Q23 Which one of the following best describes the industry sector of your organisation? *Please tick one only*

- Investment Banking ❑
- Other Banking ❑
- Investment/ Fund Management ❑
- Audit Services ❑
- Insurance/ Actuarial ❑
- Other financial services ❑
- Legal ❑
- Management consulting ❑
- Media ❑
- PR/ Marketing ❑
- IT ❑
- Telecommunications ❑
- Scientific/ Technical services ❑
- Retail/ Wholesale ❑
- Travel/ Tourism/ Leisure/ Entertainment ❑
- Other services ❑
- Construction ❑
- Transport/ Vehicle manufacture ❑
- Logistics ❑
- Utilities/ Energy/ Oil ❑
- Food/ Drink/ Tobacco/ Textile/ Clothing ❑
- Manufacturing ❑
- Engineering ❑
- Government/ Politics ❑
- Education/ Health ❑
- Charity/ Not for profit organization ❑
- Other (Please specify) ________ ❑

Q24 Does your job responsibility involve making decision about the purchase or lease (i.e. choosing the supplier or brand or authorising the payment) of any of the following type of goods or services? *Please tick all that apply*

- IT equipment/systems/services ❑
- Telecommunication equipment/systems/services ❑
- Other office equipment ❑
- Aerospace ❑
- Industrial materials/ components ❑
- Fuel/Energy ❑
- Company vehicles ❑
- Business premises/sites ❑
- Banking ❑
- Investment/Brokerage ❑
- Financial Services ❑
- Auditing Services ❑
- Legal Services ❑
- Management consulting services ❑
- Advertising / Marketing / Public relations ❑
- Human Resources ❑
- Travel services ❑
- Logistics ❑
- Conferences/Exhibitions ❑
- Other ❑
- Not involved in purchase decision making ❑

Q24a Which of the following broad areas are your main areas of activity at work? *Please tick all that apply*

- General management ❑
- Strategy/ Strategic planning ❑
- Management of particular geographical regions
- Banking services ❑
- Financial advisory services ❑
- Accountancy/ Management accountancy ❑
- Actuarial/ Insurance ❑
- Investment/ Fund management ❑
- Treasury ❑
- Other Financial ❑
- Legal ❑
- Sales ❑
- Marketing/ Advertising/ PR/ Communications ❑
- E-Commerce/ Business systems ❑
- IT/ Telecommunications ❑
- Scientific/ Technical Services ❑
- R&D/ Design ❑
- Procurement/ Purchasing ❑
- Logistics ❑
- Premises/ Property management ❑
- HR/ Training ❑
- Education/ Medical/ Health ❑
- Government/ Politics ❑
- Other ❑
- Not involved in purchase decision making ❑

Q25 How many people does the organisation that you work for employ worldwide?

- Just myself/ 1 person ❑
- 2-250 ❑
- 251-250 employees ❑
- 501-1,000 ❑
- 1,001-10,000 ❑
- 10,001+ ❑

Q26 Which region do you currently live in?

- UK ❑
- Continental Europe ❑
- USA ❑
- Americas (excluding USA) ❑
- Middle East ❑
- Africa ❑
- Asia Pacific ❑
- Other (Please specify) ________ ❑

Prize draw and mailing instructions on back

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FOLD 3

FOLD 1

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Please fully complete the FT Special Reports Survey 2011 and enter your name, address and e-mail below if you wish to be entered for the prize draw. Closing date for postal entry is Friday, 13 January 2012.

PLEASE WRITE IN BLOCK CAPITALS

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Address ....

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Postcode .... Country ....

Email ....

Mobile* (   ) ....

*** It is now possible to conduct market research through text messaging. If you are happy to participate in FT research via text messaging, please enter your mobile or cell phone number (including country code) above.**

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Banks turn to financial alchemy in search for capital

Inside business

Tom Braithwaite explores arcane ways to reduce risk

A top US regulator takes the drastic step of suspending bank capital requirements. The global crisis is so bleak that the Federal Deposit Insurance Corporation says the country needs banks to focus on lending rather than the additional stability of higher capital.

"The question," according to the FDIC, "is not whether a bank has enough capital for the type of assets which it now holds and the risks which it now appears to face, but whether it has enough capital to enable it to assume the proper and reasonable risks of participating in the financing of business enterprise."

But before Brian Moynihan of Bank of America and his fellow chief executives pop the champagne corks, I have a clarification. Although the passage is from the FDIC, I stumbled across it in the FT archives, and it comes from 1944.

Today's regulators are more hawkish. With memories of the 2008 crisis still fresh, banks round the world have been ordered to achieve a 7 per cent ratio of core capital to risk-weighted assets by 2019 as part of the Basel III reforms. The largest must reach 9.5 per cent. With European banks still too feeble to withstand sovereign defaults, they are being instructed to accelerate capital building.

How they do this will prove increasingly controversial. Anders Borg, Swedish finance minister, said in October that "the first solution [should be] withholding dividends and tapping profits". Others in his camp say raising capital in the market should be the second solution.

If policymakers want banks to raise fresh capital they are going to have to force it to happen and police it vigorously. With the share prices of the largest international banks down 30-60 per cent this year, chief executives are reluctant to inflict more pain on long-suffering shareholders (including themselves) by diluting them in an equity raising. Even Mr Moynihan, whose bank is seen as the weakest of the top five in the US, has ruled that out.

At the same time, fearful of losing top staff, banks are still preparing to pay out about 40 per cent of their revenues in salaries and bonuses this year. And the Federal Reserve has allowed most large US banks to increase their dividend pay-outs and share buy-backs, cutting the amount available to build up capital.

With this set of instructions and incentives the banks are going to do precisely what the wartime FDIC wanted to avoid: solution three – cut the size of their balance sheets, further reducing credit to a battered economy.

But there is a fourth solution that has received limited attention yet may prove crucial: magical Alice in Wonderland tricks of financial innovation. Rather than increase the numerator of the capital ratio by hurting shareholders and employees or reduce the denominator by hurting businesses and customers, bankers are quietly getting creative once more.

The opportunity comes because of regulators' decision to calculate capital rules using risk-weighted assets rather than total assets. So the safest securities, such as US Treasuries, do not count as assets at all for the ratio, but the riskiest – such as long-term structured credit assets – count at double their stated value or more.

Jamie Dimon, JPMorgan's chief executive, said in October that he intended to "manage the hell out of RWA" to reach the higher levels. Morgan Stanley revealed that its risk-weighted assets had ballooned by $44bn after the Fed said the bank was managing the hell out of its assets too much and told it to stop.

A senior executive at a third bank told me that it was scouring its balance sheet, looking for assets that could be structured differently to achieve lower risk weights. And, as the FT reported in October, hedge funds and insurers are actively involved behind the scenes, seeking new structures to buy or guarantee a slice of risk on banks' books.

So by financial alchemy, assets can be transmuted from garbage to gold – and, therefore, require less capital. A senior regulator tells me officials are fully expecting various nefarious schemes to circumvent the rules, including structured transactions that do not reduce their risk but do reduce their RWA.

This is arcane stuff and it can easily be lost in the headlines of whether Basel III is "anti-American", as Mr Dimon has said, or anti-European.

Meanwhile, regulators are all suspicious of each other – countries that adhere to the 1944 view of the world could be lenient on their banks just by turning a blind eye to risk-weight manipulation.

Whether you call it gaming the system or legitimate management, the capital hawks will need to watch both the banks and the national regulators if RWA is not to mean Really Weird Accounting.

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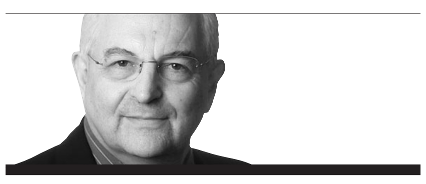
This article was originally published on October 24 2011.

Germany has to make a fateful choice



Martin Wolf

"Perhaps future historians will consider Maastricht a decisive step towards the emergence of a stable, European-wide power. Yet there is another, darker possibility. The effort to bind states together may lead, instead, to a huge increase in frictions among them. If so, the event would meet the classical definition of tragedy: hubris (arrogance); ate (folly); nemesis (destruction)."

I wrote the above in the Financial Times almost 20 years ago. My fears are coming true. This crisis has done more than demonstrate that the initial design of the eurozone was defective, as most intelligent analysts then knew; it has also revealed – and, in the process, exacerbated – a fundamental lack of trust, let alone sense of shared identity, among the peoples locked together in what has become a marriage of inconvenience.

The extent of the breakdown was not brought home by the resignation of Germany's Jürgen Stark from the board of the European Central Bank, nor by the looming Greek default, nor by new constraints imposed by the German constitutional court. What brought it home was a visit to Rome.

I heard one Italian policymaker say: "We gave up the old safety valves of inflation and devaluation in return for lower interest rates, but now we do not even have the low interest rates." Then: "Some people seem to think we have joined a currency board, but Italy is not Latvia." And, not least: "It would be better to leave than endure 30 years of pain." These remarks speak of a loss of faith in both the project and the partners.

Jean-Claude Trichet, outgoing president of the European Central Bank, has pointed to the bank's stellar counter-inflationary record, far better than the Bundesbank's. But the low inflation masked the emergence of profound imbalances within the zone and the lack of means – or will – to resolve them. As a result, a default by a major government, a break-up of the eurozone or both are conceivable. The consequent flight to safety, which must include attempts to hedge cross-border exposures in a supposedly integrated currency area, threatens a meltdown. We are witnessing a lethal interplay between fears of sovereign insolvency, emerging sovereign illiquidity and financial stress.

As designed, the eurozone lacked essential institutions, the most important being a central bank to act as lender of last resort in all important markets, a rescue fund large enough to ensure liquidity in sovereign bond markets and effective ways of managing a web of sovereign insolvencies and banking crises.

In the absence of strong institutions, the attitudes and policies of the core country have become crucial. I admire Germany's reconstruction after the second world war and after unification, the commitment to economic stability and its first-class exports. Unfortunately, these are insufficient. German policymakers persist in viewing the world through the lens of a relatively small, open and highly competitive economy. But the eurozone is not a small, open economy; it is a large and relatively closed one. The core country of such a union must either provide a buoyant market for less creditworthy countries when the latter can no longer finance their deficits, or it has to finance them. If the private sector will not provide the finance, the public sector must do so. If the latter fails to act, a wave of private and public sector defaults will occur. These are sure to damage the financial sector and exports of the core country itself, as well.

The failure of Germany's leaders to explain these facts at home makes it impossible to solve the crisis. Instead, they indulge in the fantasy that everybody can be a lender, simultaneously. For small, open economies such as Latvia and Ireland, regaining competitiveness and growth through deflation might work. For a big country such as Italy, it is too painful to be credible. Wolfgang Schäuble, Germany's finance minister, may call for such austerity. It will not happen.

Today, raging fire must be put out. Only then can attempts at building a more fireproof eurozone begin. The least bad option would be for the ECB to ensure liquidity for solvent governments and financial institutions, without limit. It should not be difficult to argue that buying bonds is compatible with continued monetary stability, since broad money has been growing at a mere 2 per cent a year. It is sure to be politically hard, however, particularly for Mario Draghi, the incoming Italian ECB president. Yet it is what has to be done given the inadequate size of the European financial stability facility if called on to help larger beleaguered euro-member countries. Politicians must then dare to support such action.

What should happen if the German government decided it could not support such a bold step? The ECB should go ahead anyway rather than let a collapse unfold. It would then be up to Germany to decide whether to leave, perhaps with Austria, the Netherlands and Finland. The German people should be made aware the results would include a soaring exchange rate, a massive decline in the profitability of Germany's exports, a huge financial shock and a sharp fall in gross domestic product. All this would be apart from the failure of two generations of efforts to build a strong European framework around Germany itself.

Germany possesses a binding veto over efforts to expand official fiscal support. But it is losing control over its central bank. In a crisis so menacing, the one European institution with the capacity to act on the requisite scale should dare to do so, since the costs of not doing so are bound to prove devastating. That will surely create a political crisis, but this would be better than the financial crisis unleashed by a failure to try.

Germany must choose between a eurozone disturbingly different from the larger Germany it expected, or no eurozone at all. I recognise how much its leaders and people must hate this choice. But it is the one they face. Chancellor Angela Merkel must dare to make that choice, clearly and openly.

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This article was originally published on September 13 2011

It is madness to follow a martingale betting strategy

John Kay

The martingale is not a songbird, but a betting strategy. Each time you lose, you increase your stake: to the point at which a win on the next game would recoup all your losses and leave you ahead.

Since you will win sooner or later, you are certain to come home with a small profit. Provided you are infinitely rich before you start. Otherwise, if you regularly engage in martingales, you will eventually go bankrupt – and the richer you are, the larger the scale of bankruptcy.

Since anyone who studies the problem knows that ruin is the outcome, your bank, or your bookmaker, will probably call a halt to the game while the shirt remains on your back. Such capitulation will leave you with a large loss, and an enduring grievance that others have deprived you of a great coup.

Martingales and related strategies are the familiar currency of financial markets. Risk managers struggle, not always successfully, to control the martingales of rogue traders. Loan covenants may specify that when your initial collateral becomes insufficient you must offer more. Governments have responded to each recent financial crisis by feeding enough money into the market to stave off immediate collapse.

Bold risk-taking has always been characteristic of the European Union. The architects of the European project believed that if the mechanics of integration were developed rapidly, the institutions and electorates of member states, and the degree of real economic integration across national boundaries, would eventually catch up. This approach has mostly worked. But as with most gaming systems, it works until it doesn't.

Whenever European institutions have failed to end the current crisis, they have returned with a new, larger, commitment. "We will do what it takes" is the strategy, if it can be called that. "Just in time, just enough", is how my colleague Martin Wolf described the tactics in late November. These are the key parts of the martingale system. But debt markets illustrate a malevolent game. A player on the other side of the table – global financial markets – has very large resources, and can ensure that each round can be played for very large stakes.

> Martingales and related strategies are the familiar currency of financial markets

The wise person's reaction to the casino is not to go there. The next best course is to plan an early night. Leave while you are ahead, and if you cannot do so, accept a small loss. If the eurozone had quickly recognised defeat in Greece, it would have suffered a manageable failure. Instead it has followed the martingale. As the size of the bet grows after a run of losses, the commitment to do what it takes becomes steadily less credible.

The gambler who is confident his system will work looks to rich friends. When the indulgence of Berlin was exhausted, a banker was dispatched to Beijing. Now the players look to the only remaining credible supporter. Surely the European Central Bank can enable them to see the night through. The ECB really does have infinite resources: if it runs out of money, it can print more.

Up to a point. Money created by a central bank is not free – if it were, we could all be as rich as Croesus. The resources of a monetary agency come either directly from taxpayers or indirectly from everyone through general inflation. To fund the bet the ECB would have to stand ready to buy not just every eurozone government bond issued so far, but any that might be issued. And more. The subprime and Lehman failures demonstrated that the amounts of money that could be gambled on default were potentially far larger than the actual amounts at risk.

Of course, say the advocates of this course, if only the banker would promise to underwrite our losses he would not actually have to pay. If you will only lend me a bit more money, says the gambler, you will get it all back, and more. That is the seductive song of the martingale.

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This article was originally published on November 22 2011.

The FT's Year in Finance

Emperor Corzine and his Goldman clothes

John Gapper

Once upon a time, there was an emperor who had been thrown out of the kingdom of New Jersey and was seeking another place to rule. Corzine, for that was his name, opened his wardrobe at home one day and spotted some clothes glimmering at the back.

Years before, when the emperor had ruled the illustrious merchant house of Goldman, he had also been forced to leave. To compensate him, the Goldman merchants had woven a suit and cloak out of what they assured him was their finest fabric. "These clothes will shield you always," said Paulson, the partner who had taken the emperor's wreath. "If implied volatility spikes in the ducat options market, put these on and all will be well."

Emperor Corzine donned the Goldman clothes and regarded himself in the mirror. His cloak looked threadbare and he thought he could spy his naked legs through the cloth. "That is impossible," he said to himself. "Goldman garments last for ever, even in public service. My eyes are deceiving me."

The emperor wandered along Wall Street and saw that the passers-by were staring at him, so he told them where his clothes had come from. They immediately realised they were seeing things. They had mistaken him for a tramp heading to Occupy Wall Street's camp for breakfast, but he was clearly an aristocrat.

The emperor came across a small merchant house called MF Global where humble traders were selling sugar and bales of wheat. "This reminds me of the farm in the land of Illinois where I grew up," the emperor said to himself. "Perhaps I can help them to find prosperity."

The emperor had another thought. After he left the house of Goldman, he had been appointed a senator in the Columbian district, but had never become High Treasurer and been permitted to sign the green banknotes that were used throughout all realms. Other Goldman partners had achieved this office, including Paulson and a wily vizier called Rubin. He envied them.

Emperor Corzine resolved to take over this small trading house and make it a rival to Goldman. That would provoke envy among the merchants who had rejected him and the peasants of New Jersey. The peasants had stormed the emperor's palace in Trenton one day, led by a rotund baron called Christie, who spoke their language.

The emperor was ushered into the presence of MF Global's traders. The partners greeted him warmly, saying that they were in sore need of his leadership because many unusual events had occurred. "There have been fierce storms in this parish of late and a flock of black swans has swum up the East River and is hissing at us," one said.

"Fear not the black swans," the emperor assured the traders. "The weather will revert to normal and white swans will return. Trust me – I've been around the block a few times. Let me tell you of an arbitrage trade I did on the bonds of sovereigns many years ago. It took time to work but I harvested many gold coins."

Some of the traders wondered if they should heed the emperor. He was oddly attired and his beard was grey. Perhaps he is just re-living past glories, they thought to themselves. But the emperor showed them the label sewn inside his worn-out suit. "Goldman," they said admiringly. "They are the finest of weavers. We were wrong to doubt him."

Shortly afterwards, a messenger arrived from far-off lands with tales of great events. The grand emperors of France and Germany had settled an argument and lent florins to the southern kingdoms that had debased their currency. "We should load up," Emperor Corzine cried. "We must trade in size. Here," he told the treasurer. "Borrow 40 more bags of coins like this one. Wear my cloak and no one will refuse you."

Then one of the MF Global traders summoned his courage and spoke up. "My Lord, are you certain about this?" he said. "The weather is still stormy, and one of the black swans bit my leg on my way along Wall Street this morning. It left a nasty gash. These are strange and unsettling times. Can we trust our cousins from the old lands?"

The emperor thrust out his arm angrily and a sleeve appeared to fall off his suit, though the traders knew that it could not be so. "You are a mere trader and you do not hobnob with kings and queens, as I often do. An emperor's word is his bond and these bonds will fetch a nice spread in the repo market. With a bit of leverage, it's easy money."

For a time, all was well and gold coins piled up in the trading house's treasury. There were so many that it was difficult to keep track of which belonged to the traders and which to the farmers whose commodities they bought and sold. Sometimes, the coins got mixed up in the same bags.

Then one day, bad tidings were received from the Athenian empire. The northern emperors had ordained that their bankers be taken outside and given a haircut. Half of the bankers' hair had been shorn, and still the Athenian peasants wanted more. "How can this be?" the emperor said in dismay. "I warned them against democracy."

An angry crowd of farmers was gathering outside on Wall Street and, as they burst through the doors to demand their coins back, one of the farmers' children pointed at Emperor Corzine in wonder. "He has no clothes," the boy cried.

The traders turned to the emperor and realised that the child was right – he had been trading naked all along. Then they saw that he was stuffing yards of the most exquisitely shiny silk into a canvas sack. "I put this in my contract," the emperor said. "It's a golden parachute."

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Bob Diamond in an unconvincing defence

Martin Wolf

Talk is cheap. Action is expensive. But Bob Diamond's inaugural Today Business Lecture was clever talk. The chief executive of Barclays, one of the UK's iconic banks, sought to convince his BBC radio audience that the banks are dedicated to supporting economic growth, by taking risks on behalf of businesses, big and small. No doubt, he believed every word. But should you? No.

Mr Diamond is one of those clever investment bankers who, as my colleague John Kay has noted, now manage most important global banking institutions. He focused on rebuilding trust. Trust does indeed need rebuilding: at a private discussion of the final report of the Independent Commission on Banking, on which I served, a Conservative member of parliament stated that one of the few issues on which all constituents agreed was their loathing for the bankers.

Mr Diamond argued that banks need to show they support growth, accept responsibility for what has gone wrong and "become better and more effective citizens". On the first, he argued that banks help the economy by taking risks. On the second, gone was earlier talk about an end to the "period of remorse and apology". Instead, we had more remorse, along with insistence that "no taxpayer money should ever again be put at risk to rescue a failed or failing bank". On the last, he stated that, among other things: "Business must increase profits in a way that creates sustainable value, not just short-term gain."

It makes one feel all warm, does it not? So why am I cynical? I look at incentives and behaviour, not words.

In a recent Wincott lecture, Andrew Haldane, executive director of financial stability for the Bank of England, pointed to the perverse incentives caused by limited liability, excessive gearing, the tax benefits for debt, and government insurance.

Did the economy at least benefit from the run-up in leverage? Hardly. We saw huge rises in banks' exposure to one another, which worsened systemic fragility, and in the prices of – and debt secured against – property. Who thinks these provided durable benefits?

Mr Haldane also noted: "The purchaser of a portfolio of global banking stocks in the early 1990s is today sitting on a real loss. So who exactly is extracting value from these incentive distortions? The answer is twofold: short-term investors and bank management."

It is not enough for banks to accept the principle of "strong regulation", as Mr Diamond does. We need to see changes in how banks manage themselves if we are to believe in protestations of reform.

First, bank managements must stop targeting returns on equity that are unadjusted for risk, particularly ones as high as 15 per cent, as I have argued on the Wolf Exchange. The easy way to achieve such targets is to raise leverage – a practice concealed behind the smokescreen of risk-weighting of assets. Robert Jenkins, a member of the financial policy committee of the Bank of England, puts it well: "Return on equity is the wrong target. Over the past 10 to 15 years it has helped to make many bankers rich and loyal shareholders poor. Moreover, it prompts banks to fight to keep loss absorbing capital low. This makes their enterprises vulnerable and our financial system fragile. As the key driver of bank behaviour it has to go." Amen.

Second, banks should welcome attempts to raise capital and lower gearing, over time. This is also the best way to make Mr Diamond's intention that we will never again need to rescue banks at all plausible. As things stand, this is "time inconsistent" – a promise unlikely to be fulfilled. Better-capitalised banks would be more resilient. Furthermore, this must be real capital against actual assets. The turmoil in markets for supposedly safe sovereign debt shows why risk weights can be so dangerous.

Third, banks should join with other businesses in a campaign to end the distortions in corporate taxation in favour of debt. There is too much debt in the economy. The consequences have been dire.

Finally, UK banks should welcome the ICB's proposal of a ringfence for the domestic retail bank, partly because it would facilitate the resolution in which they believe and because it would contribute to restoring a service culture to retail banking. But banks should also be brave enough to say that, at current low interest rates, the free-if-in-credit model of banking is unsustainable. If customers want the services banks provide, they must expect to pay for them directly. Otherwise, scandals are almost certain to recur.

These changes are the minimum needed for a banking system run in the interests of shareholders, customers and the economy, not bankers. I hope for speeches from Mr Diamond and his peers on such lines. I am not holding my breath.

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